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Update

Income Trusts Law

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Department of Finance Provides Guidance on "Normal Growth" for Income Trusts

On December 15, 2006, the Department of Finance released guidance for income trusts and other flow-through entities that qualify for the four-year transitional relief from the new income trust tax. The guidance establishes objective tests with respect to how much existing income trusts are permitted to grow without jeopardizing their transitional relief.

Background

On October 31, 2006, the Minister of Finance announced the introduction of a tax on income trusts and other publicly traded flow-through entities. While new income trusts are immediately subject to these rules, existing income trusts that were publicly traded before November 1, 2006 are exempt from this tax until their 2011 taxation year. However, the Minister of Finance cautioned that although there was no intention to prevent "normal growth" during the transition period, the "undue expansion" of an existing trust might result in the loss of its transitional relief.

Since the announcement of the income trust tax proposals, uncertainty over the meaning of the terms "normal growth" and "undue expansion" had caused many income trusts to defer acquisitions and equity issues until further clarification was provided. The Department of Finance has now released guidance on the concept of "normal growth".

"Normal Growth"

In general terms, an income trust is permitted to issue new equity in each of the next four years equal to the greater of $50 million and a "safe harbour" amount. The safe harbour amount is equal to a specified percentage of the income trust's market capitalization at the end of trading on October 31, 2006.

Period	Safe Harbour
2006/2007	40%
2008	20%
2009	20%
2010	20%
	100%

The safe harbour amount is cumulative to the extent it is not fully utilized in a given year, but the $50 million limit is not. Generally, therefore, income trusts with a market capitalization of $250 million or more on October 31, 2006 may double their equity over the next four years, while smaller cap income trusts may more than double, adding between $200 million and $250 million of new equity. Because the $50 million limitation is not cumulative, smaller cap income trusts should pay close attention to the potential timing of their equity issuances. By limiting access to capital, this rule may make it difficult for some trusts – particularly smaller to mid-sized business trusts – to compete for acquisitions with corporations in their sector and to execute on their strategic plans for growth.

For the purpose of calculating the market capitalization of an income trust, only issued and outstanding units on October 31, 2006 will be counted – equity substitutes such as options, convertible debentures and exchangeable shares and partnership units are not included in the calculation, nor is debt (whether or not itself publicly traded). Income trusts with significant retained interests in the form of these instruments may well question why market capitalization is not calculated on a fully diluted basis.

Permitted Financing Activities

In connection with the proposed limits on equity issuances, guidance was also provided with respect to certain related financing activities.

- *Non-convertible debt:* the issuance of non-convertible debt will not count towards the equity growth limits set out above. Accordingly, to the extent that acquisitions are financed with non-convertible debt, the dollar value of such acquisitions may significantly exceed the permitted growth thresholds. This will likely lead certain income trusts to reconsider their desired leverage. Moreover, as income trusts consider converting to corporate form, their appetite for debt financing may increase, which in turn will enhance their ability to grow through acquisition.
- *Equity financing of existing debt:* equity issues used to repay debt that was outstanding as of October 31, 2006 will not count towards the growth limits. This relief is significant for a number of income trusts that had bridge-financed acquisitions prior to October 31, 2006 in anticipation of completing subsequent equity offerings. Moreover, it is possible that an income trust's ability to issue equity may be increased if the proceeds of a unit issue are used to repay existing debt, and new debt is raised to fund an acquisition.
- *Convertible/Exchangeable Securities:* equity issued pursuant to the exercise of conversion rights in debt or exchange rights in shares and partnership units will not count towards the growth limits, provided such rights were in place on October 31, 2006. However, new issuances of convertible debt will be treated as equity issuances for purposes of applying the growth limits. The Department of Finance warned that if attempts are made by income trusts to develop other such substitutes for equity, those might be included as well.
- *Mergers/Reorganizations:* the merger of two or more income trusts that were publicly traded before November 1, 2006, or a reorganization of such a trust, will not affect the calculation of the growth limit to the extent that there is no net addition to equity as a result of the merger or reorganization.

The guidance reiterated the warning contained in the income trust tax proposals that transitional relief is conditional on existing income trusts respecting the policy objectives of the proposed rules. The Department of Finance stated that it would monitor developments in the market and take action accordingly to ensure that the guidance was respected.

Conversions of Trusts to Corporations

The Department of Finance also stated that it intends to permit income trusts to convert to corporations without tax consequences to investors, and that it will continue to examine the merits of appropriate rules to facilitate conversion. Although such a transaction could, arguably, be undertaken using existing rules (such as a section 85 rollover), the resulting structure may be cumbersome and less than fully tax efficient. A rule which permits a tax-neutral dissolution of any trusts or other entities within the applicable structures may ease, and perhaps accelerate, the decision for some income trusts to convert to corporate form. Although not mentioned in the guidance, shareholders that realized capital gains on the initial conversion to an income trust may question whether an offsetting capital loss should be provided on a re-conversion, so that their tax position remains as if neither transaction took place.

Notably absent from the guidance is any clarification of the rules regarding real estate investment trusts. A number of technical matters also remain to be addressed, and industry groups may ask the Department of Finance to revisit certain policy choices. Individual income trusts may also approach the Department of Finance for guidance on specific transactions or situations. Nonetheless, the guidelines should provide the clarity for many income trusts to proceed with permitted acquisitions and capital market transactions.

For further information, contact:

Maureen Berry
mberry@goodmans.ca 416.597.4287

Alan Bowman
abowman@goodmans.ca 416.597.4209

Jon Northup
jnorthup@goodmans.ca 416.597.4228

Stephen Pincus
spincus@goodmans.ca 416.597.4104

Mitchell Sherman
msherman@goodmans.ca 416.597.4189

Carrie Smit
csmit@goodmans.ca 416.597.4230

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